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Too Late to the Oil Party? Consider an Alternative (Part II)

Timothy D. Kailing

Occasionally, one gets it right. In my market comment last month ("Too Late to the Oil Party? Consider an Alternative"), I remarked:

Though I am a long-term bull on energy, oil has already more than tripled in the past four years. In my view, after this move, the probability of major price corrections and volatility is currently very high.

While I was on vacation for the first three weeks of July, I was very glad to be out of all investments tightly correlated to conventional energy, after happily riding them for several years.

However, the alternative energy sector -- which I believe is due for a major positive move in the medium to long term -- has not exactly lit things up this last month. Most of the major stocks are flat to down, with the PowerShares WilderHill Clean Energy ETF ([PBW](#)) on which I focused in my analysis, down just over 10% in that time.

But this is all in absolute terms, and when it comes to markets, I believe in a financial principle of relativity: all performance is relative. And when you look at the relative performance of PBW and the oil ETF ([USO](#)) it looks like, in relative terms, the party for alternatives may have already begun.

Financial Relativity: The Special Relativity of Oil and Alternative Energy

The chart below is a depiction of the relative performance of PBW

versus USO for the last year (click to enlarge image):



During the last two weeks, where the arrow indicates, a major linear trend in the relative price of PBW and USO looks to have statistically broken. For the previous six months, alternative energy consistently lagged conventional energy, but during the recent pullback in oil, this relationship has broken out of its statistical "channel". Whether this is a mere "test" or the beginning of a true reversal is yet to be seen, of course. But for a long-term investor confident that alternative energy has the fundamentals of supply and demand on its side, it is a sign that the wait for a bullish move may soon be over.

Beyond market fundamentals, I think that the upcoming election may provide a catalyst for capital flow towards alternative energy equities. Unless oil prices really tank over the next few months -- back into the sub-100 dollar range per barrel, which I don't expect -- I believe it's quite likely that Obama and McCain will get into an escalating battle about who is more supportive of alternative energy. This sort of attention would provide additional support for the sector and help it to break out of its six-month trend of underperformance relative to conventionals.

The most direct way to apply the financial principle of relativity is

through pair trading, or through more complex variations on the same theme. Properly executed, these strategies can allow one to play the relative performance of alternative energy versus oil, for example, while remaining agnostic regarding the absolute price of oil.

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.... The relative movement chart of PBW and USO above is a "shadowless" variant of the traditional candle chart, with up days (close > open) in white and down days (close < open) in black; it efficiently shows the recent increase of buying interest in alternative energy relative to oil.

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As in my market comment a month ago, for this analysis I use PBW, the PowerShares WilderHill Clean Energy ETF, as a proxy for alternative energy, but there are a number of analogues which are fairly closely correlated with PBW. These include the PowerShares WilderHill Progressive Energy ETF ([PUW](#)), PowerShares Cleantech ETF ([PZD](#)), and the Market Vectors Global Alternative Energy ETF ([GEX](#)). There are, of course, many major individual equities in the alternative energy space, such as Evergreen Solar ([ESLR](#)), First Solar ([FSLR](#)), JA Solar ([JASO](#)), Energy Conversion Devices ([ENER](#)), Suntech Power ([STP](#)), and Trina Solar ([TSL](#)); although individual equities in a rapidly expanding industry tend to be very volatile, and are not for the faint of heart.

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